State Notes

TOPICS OF LEGISLATIVE INTEREST
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Predatory Lending
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Though not defined in Michigan or Federal law, predatory lending typically involves harmful or fraudulent sales tactics as well as abusive loan terms and practices perpetrated primarily by mortgage brokers and lenders, and sometimes real estate appraisers, at the expense of mortgage loan applicants and borrowers. At particular risk are borrowers and loan applicants who do not have access to the prime market and are subprime borrowers. The subprime market consists of borrowers who do not qualify for prime or best lending rates or who qualify only for risky nontraditional loans with adjustable rates and interest-only payment options because of their deficient credit history.

Below is a brief overview of a few specific types of predatory lending, legislation and regulations that could be implemented in Michigan, and examples of potential State intervention.

At-Risk Consumers

Although predatory lending can occur in virtually any lending market, subprime borrowers are especially vulnerable to the fraudulent or deceptive lending practices and unfair or extreme loan terms that comprise predatory lending.[1] Subprime borrowers usually are those who cannot qualify for traditional mortgages with competitive interest rates and fees, due to poor credit histories or adverse financial situations. Because of targeted predatory lending practices and borrowers' lack of knowledge about mortgages and lending, even some borrowers who might qualify for prime loans end up in the subprime market. The problem in Michigan, however, extends beyond the subprime market, as indicated by mortgage payment delinquency rates in the State that are approximately double the national average in all mortgage loan categories.[2] Because of the complexity of nontraditional loans, including interest-only and adjustable rate mortgages, people who take out these loans also may be subjected to predatory lending practices.

Predatory lenders often target certain demographic populations, including the elderly, racial and ethnic minorities, and borrowers with little knowledge of mortgage or finance. According to *Curbing Predatory Home Mortgage Lending*, a joint report by the U.S. Department of Treasury and U.S. Department of Housing and Urban Development (HUD), when controlling for income, people who live in predominantly African-American communities refinance using subprime markets much more often than do residents of predominantly white communities.

Types of Predatory Lending

While the Federal government has been primarily responsible for laws pertaining to disclosures about fees that mortgage brokers must make to borrowers, states tend to regulate mortgage broker, lender, and appraiser practices.[3] States have the ability to make significant changes in

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[1] "Curbing Predatory Home Mortgage Lending: A Joint Report National Predatory Lending Task Force", HUD and U.S. Department of Treasury, June 2001.
[2] Pollock, Alex J., "The Subprime Bust and the One-Page Mortgage Disclosure", submitted to the Senate Committee on Banking and Financial Institutions, 11-28-07.
[3] "Curbing Predatory Home Mortgage Lending".

the way that principal actors behave in the lending process, specifically in instances in which a broker, lender, or appraiser intentionally deceives a borrower or obscures the lending process in order to take advantage of a borrower.

Loan Flipping. Throughout the course of a mortgage, a borrower may refinance for several purposes, including to secure a lower interest rate or consolidate debt. In order to receive tangible benefits such as a lower interest rate, or the ability to meet scheduled payments, a borrower can expect to be charged an origination fee on any new principal added to the loan through refinancing.

Loan flipping occurs when a lender encourages a borrower to refinance his or her loan even though the borrower would receive no real benefit from doing so. Instead of charging origination fees on additional principal only, loan flipping lenders may charge high fees on the entire amount of the loan, effectively recharging a borrower for the same loan and diminishing any equity in the home.

Loan flipping is not prohibited in Michigan. As noted below in Table 1 (which identifies predatory lending loans in Michigan and six neighboring states), Illinois, Kentucky, Minnesota, Ohio, and Wisconsin ban the practice, as do several other states. Some people believe that prohibiting the practice can save many borrowers from outright fraud as loan flipping, by definition, has no conceivable benefits for the borrower. It also has been suggested that any legislation banning loan flipping should be specifically targeted to the practice, as overly strict or broad prohibitions or restrictions on certain lending fees and practices could be detrimental to legitimate refinancing that is beneficial to a borrower.[4] For example, legislation in Minnesota prohibits "churning", which means "knowingly or intentionally making, providing, or arranging for a residential mortgage loan when the new residential mortgage loan does not provide a reasonable, tangible net benefit to the borrower considering all of the circumstances including the terms of both the new and refinanced loans, the cost of the new loan, and the borrower's circumstances".[5]

Disregard for a Borrower's Ability to Repay. A borrower's credit history and job stability are important factors used by a lender to determine the borrower's ability to repay a loan and the conditions of that loan. When assessing the eligibility of a potential borrower, a broker or lender should evaluate the borrower's ability to pay the loan using liquid assets, including income. Asset-based lending, on the other hand, occurs when a lender decides whether to make a loan based on nonliquid sources of value, specifically a house. In addition, some brokers base loan decisions on "stated income" without verification and without regard to taxes and other general living expenses.

According to the National Conference of State Legislatures, debt-to-income ratio is a good indicator of the ability to repay a loan. Requiring a lender or broker to give "due regard" to this ratio, or specifying a ratio that a borrower must meet, protects against asset-based lending and increases the likelihood that a borrower will repay a loan.

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[4] "Curbing Predatory Home Mortgage Lending".
[5] Chapter 18, Section 23 of the Laws of Minnesota.

In Michigan, a lender is not required to consider the debt-to-income ratio of a prospective borrower and there otherwise is little to prevent a lender from making a loan to a borrower who does not have the ability to repay. Debt-to-income ratio provisions have been added to state laws in Illinois, Indiana, Kentucky, Minnesota, Ohio, Wisconsin, and several other states. Some states, including Illinois, Kentucky, and Ohio, establish a presumption at 50.0% (debt to income) while others require a lender to verify the ratio of a potential borrower or to give it due regard.

Recently, the Federal Reserve Board proposed new rules and restrictions designed to eliminate mortgage loans to borrowers who obviously have no ability to pay. According to the rules, a broker or lender would have to verify and document a borrower's ability to repay a loan and demonstrate that future changes in payments would be covered by the projected income of a borrower.[6] It is unclear what effect the rules, if adopted, will have on predatory lending practices.

Expedited Services. A borrower's lack of understanding of a loan or the mortgage process may be compounded by quick transactions and a flood of information. Because of the complicated nature of mortgages, borrowers often are misinformed about the details of a loan, either intentionally or otherwise, and sometimes are under the impression that quickly agreeing to the terms of a mortgage is necessary. Furthermore, a broker might indicate that a mortgage is available only for a limited time and that extended consideration of the consequences of borrowing could be detrimental to the borrower. Some people believe that prescribed waiting periods after loan applications, in combination with mandatory credit counseling, could minimize the opportunity for lenders to take advantage of rushed decisions and misunderstood loan terms.

Coerced/Inflated Appraisals. Some mortgage lenders make an appraisal job contingent on a preconditioned outcome of the appraisal, request that an appraiser review an undesirable appraised value, threaten to take future business to other appraisers if a predetermined appraised value is not met, or refuse to pay for appraisal services already rendered when a requested appraised value is not returned. Even though many appraisers strongly oppose coerced and inflated appraisals, reportedly it can be difficult to work as an appraiser in the current real estate market without acquiescing to the suggestions or demands of mortgage lenders. Inflated appraisals can exacerbate the burden on a borrower by creating a debt that is more than his or her property is actually worth.

In Michigan, Senate Bills 342, 343, and 356 were introduced to address certain appraisal practices, specifically the inflation of an appraisal. Supporters of the bills believe that they would help to eliminate appraiser and lender misconduct in Michigan, and would enable appraisers to oppose the practice of inflating appraisals without fear of reprisal. (The bills have passed the Senate and been referred to the House Committee on Banking and Financial Services. A more detailed analysis of the bills is available at www.legislature.mi.gov.)

Prepayment Penalties. Many subprime and nontraditional mortgage products contain prepayment penalty clauses that charge the borrower a fee for paying off a mortgage before the term of the loan has ended. Prepayment penalties prevent borrowers from accelerating the payment of their loans and from refinancing loans at lower rates.

[6] Andrews, Edmund L., "In Reversal, Fed Approves Plan to Curb Risky Lending", *New York Times Online*, 12-19-07.

Prepayment penalties are legal in Michigan and, when offered transparently, allow brokers and lenders to protect profits in risky markets. Prepayment penalties are problematic when they are not clearly disclosed to the borrower or when they are in excessive amounts.

As of July 26, 2007, six states and the District of Columbia had banned prepayment penalties.

Balloon Payments. A balloon payment covers the remaining principal at the end of a loan, which must be paid off in one lump sum. Evidently, balloon payments are frequently large enough that a borrower must apply for a new loan to make the balloon payment. As with prepayment penalties, balloon payments are legal components of loan packages, but can present a problem if the borrower does not completely understand the tradeoffs being made.

Table 1

Predatory Lending Laws

	Flipping Banned	Prepayment Penalties/Fees Banned	Debt to Income Ratio Provision	Consumer Credit Counseling Provision
Michigan	**No**	**No**	**No**	**Notification**
Illinois	Yes	No[1)]	Yes	Notification
Indiana	No	No	Yes	Third Party Required
Kentucky	Yes	No[1)]	Yes	Notification
Minnesota	Yes	No	Yes	Notification[2)]
Ohio	Yes	No	Yes	No
Wisconsin	Yes	No	Yes	Notification

[1)] A bill was introduced in 2007 to ban prepayment penalties/fees in certain situations.
[2)] A bill was introduced in 2007 to require credit counseling in certain situations.

Source: The National Conference of State Legislatures (http://www.ncsl.org/programs/banking/bankmenu.htm)

Potential Intervention

Broker/Lender Regulation. In addition to adopting the measures described above, Michigan could prioritize the enforcement of current consumer protection and other laws prohibiting aggressive and fraudulent sales practices, and aim to eliminate brokers and lenders who intentionally mislead or defraud borrowers. Senate Bills 826 through 833, along with House Bills 5287 through 5291, would create the Mortgage Industry Advisory Board, require the registration of mortgage loan officers, establish continuing education requirements for loan officers, prohibit loan officers from engaging in fraud, deceit, or material misrepresentation, and extend administrative and criminal penalties to loan officers who violated the law. Some people believe that the bills would address the problem of predatory lending by increasing the professionalism on the broker side of a loan and minimizing the access of bad actors to an already volatile market. (Senate Bills 826 through 833 have passed the Senate and, like the House bills, have been referred to the House Committee on Banking and Financial Services. A more detailed description of the bills is available at www.legislature.mi.gov.)

One-Page Mortgage Disclosure. Another basic tool that could be used to increase borrowers' understanding of their mortgages and transparency in the broker and lending processes is the one-page mortgage disclosure.[7] The disclosure would contain key information about a mortgage, including the amount, type, duration, and fully indexed rate of the loan as well as prepayment fees, indicate balloon payments, and identify potential rate adjustments. The disclosure also would state clearly the monthly income on which the loan was based and the relationship between the amount of the loan and the actual appraised value of the property. At the very least, the disclosure would illustrate the big picture of the loan to the borrower and provide the transparency that is lacking in some mortgage transactions.

Though not limited to one page, a mortgage application form containing "The Basic Facts About Your Mortgage Loan" would be required in Michigan by Senate Bill 924. (That bill has been referred to the Senate Committee on Banking and Financial Institutions.)

Consumer Credit Counseling. Compared with an uninformed borrower, an educated borrower has a better chance of getting a fair and affordable mortgage. Some states require that borrowers receive credit counseling or other information about the risks involved in borrowing and the options available to them. Many states, including Michigan, require lenders to provide loan applicants with a written notice regarding the value of receiving credit counseling before taking out a mortgage loan. It has been suggested that by requiring subprime and nontraditional loan applicants actually to receive credit counseling, the State could protect borrowers from predatory lending without restricting the types of loans available to them and without eliminating products offered by brokers and lenders.

Conclusion

Nontraditional mortgages, including those in the subprime market and adjustable rate mortgages in both the subprime and prime markets, can be valid tools to help borrowers purchase houses. To protect borrowers, however, the law could require mortgage transactions to be transparent while ensuring that the products are available only to qualified candidates.

For more information on predatory lending in the United States, please see *Curbing Predatory Home Mortgage Lending*, the joint report by HUD and the U.S. Department of Treasury.

[7] Pollock, Alex J.